

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Champion International Corporation : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law for :
the Years 1974 - 1976. :

State of New York }

ss.:

County of Albany }

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 5th day of October, 1984, he served the within notice of Decision by certified mail upon Champion International Corporation the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Champion International Corporation
One Champion Plaza
Stamford, CT 06921

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
5th day of October, 1984.

David Parchuck

James A. Haggard
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of
Champion International Corporation : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision :
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Franchise Tax under Article 9A of the Tax Law for :
the Years 1974 - 1976.

State of New York }
County of Albany } ss.:

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 5th day of October, 1984, he served the within notice of Decision by certified mail upon John M. Winter the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

John M. Winter
Champion International Corporation
One Champion Plaza
Stamford, CT 06921

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
5th day of October, 1984.

David Parchuck

William A. Hancock
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

October 5, 1984

Champion International Corporation
One Champion Plaza
Stamford, CT 06921

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
John M. Winter
Champion International Corporation
One Champion Plaza
Stamford, CT 06921
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
CHAMPION INTERNATIONAL CORPORATION	:	DECISION
for Redetermination of a Deficiency or for	:	
Refund of Franchise Tax on Business Corporations :	:	
under Article 9-A of the Tax Law for the Years	:	
1974, 1975 and 1976.	:	

Petitioner, Champion International Corporation, One Champion Plaza, Stamford, Connecticut 06921, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the years 1974, 1975 and 1976 (File No. 33387).

A formal hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, State Office Campus, Albany, New York, on November 10, 1983 at 1:30 P.M., with all briefs to be submitted by February 23, 1984. Petitioner appeared by John M. Winter, Esq. and Lee T. Scher, Esq. The Audit Division appeared by John P. Dugan, Esq. (Patricia L. Brumbaugh, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly required petitioner to include its timber holdings in the business allocation formula at net book value.

II. Whether petitioner is entitled to defer the entire gain on the sale of timber to the year of sale, notwithstanding that for federal corporation income tax purposes, it may recognize a portion of the gain in a prior year when the timber is cut.

FINDINGS OF FACT

1. Subsequent to the conduct of a field audit, the Audit Division issued to petitioner, Champion International Corporation ("Champion"), two notices of deficiency dated January 9, 1981, asserting additional franchise tax due under Article 9-A of the Tax Law for the years 1974 and 1975 in the respective amounts of \$66,482.42 and \$53,193.22, plus interest. On January 9, 1981, the Audit Division also issued to Champion a Statement of Tax Reduction or Overpayment, indicating an overpayment made for 1976, plus interest accrued thereon, in the total amount of \$35,380.95; this amount was credited against the deficiency asserted for 1974 and thereby consumed.

2. Champion is a major forest products enterprise, engaged in the manufacture and marketing of building materials, paper and related products, and home furnishings. It owns or controls land and timber resources in the United States, Canada and Brazil. It was organized under the laws of New York and began doing business in this state in 1937.

3. For the years under consideration, petitioner calculated the property factor of its business allocation percentage, as follows:

(a) 1974	<u>NEW YORK</u>	<u>EVERYWHERE</u>
Average value of real estate owned	\$ 8,367,677	\$1,774,418,308
Average value of real estate rented	11,904,392	168,645,576
Inventories owned	6,315,751	240,706,489
Total	<u>\$26,587,820</u>	<u>\$2,183,770,373</u>
Percentage in New York	1.217519	

(b) 1975		
Average value of real estate owned	\$ 8,233,651	\$1,784,436,538
Average value of real estate rented	9,505,352	189,564,416
Inventories owned	5,497,078	230,578,010
Total	<u>\$23,236,081</u>	<u>\$2,204,578,964</u>
Percentage in New York	1.053992	

(c) 1976	<u>NEW YORK</u>	<u>EVERYWHERE</u>
Average value of real estate owned	--	\$1,380,049,928
Average value of real estate rented	\$ 6,185,232	197,125,704
Inventories owned	7,314,365	268,959,057
Other tangible personal property owned	8,649,537	639,748,023
Total	<u>\$22,149,134</u>	<u>\$2,485,882,712</u>
Percentage in New York	.8909967	

Petitioner's timber valuation staff is responsible for, among other things, the development of the fair market value of petitioner's timber for purposes of the business allocation formula. (The valuation methodology is discussed infra.) The remainder of petitioner's property is included in the formula at net book value, because it is prohibitively expensive to annually appraise all of Champion's tangible assets.

The balance sheets attached to and submitted with petitioner's federal corporation income tax returns for the years 1974 through 1976 show the following average book value for its real and tangible personal property at the end of each of such taxable years:

	<u>1974</u>	<u>1975</u>	<u>1976</u>
Inventories	\$ 218,707,993	\$ 240,184,709	\$ 297,733,406
Plant, property and equipment, less accumulated depreciation	588,244,509	472,868,320	550,359,619
Construction in progress		138,412,498	62,366,262
Timber and timberlands, less depletion	246,364,440	241,316,879	241,179,319
	<u>\$1,053,316,942</u>	<u>\$1,092,782,406</u>	<u>\$1,151,638,606</u>

The difference between the value of petitioner's property in the business allocation computation and the value reflected in the balance sheet is approximately \$1 billion for each of the years at issue, and arises from the use of varying valuation methods for petitioner's timber (fair market versus book, respectively).

4. Petitioner's timber valuation department is comprised of a director and three professional foresters. It is the responsibility of the department

to develop the fair market value of petitioner's timber assets for various purposes, including the preparation of petitioner's federal and state tax returns. Each forester is assigned to a geographical operating area. The foresters assemble all the relevant data regarding timber transactions occurring in their respective areas to compile the "transactional data base"; they examine the quality of the timber involved in the transactions and analyze the costs incurred to log and deliver the timber to the mill. In addition, the foresters examine petitioner's mature timber which will be logged during the year to ascertain the type and quality of timber and the logging costs which will be incurred. These determinations are then compared with the data base to arrive at a fair market value, which when multiplied by the volume of petitioner's entire timber holdings yields the total fair market value of petitioner's timber. Petitioner's valuation is based on the assumption that the assets can be parceled, i.e., sold to various purchasers over a reasonable time period, and is thus a measure of the highest and best use of the assets.

5. The Audit Division considered the above-described valuation (used in petitioner's property factor) excessive, after comparing it to the value of the corporation based on the selling price of the stock and to replacement costs as reported by petitioner to the Securities and Exchange Commission.

The corporation tax examiner attempted to value Champion by using the average prices of its stock for each of the years at issue, according to Moody's indices. The average market value of petitioner's equity as so determined was in excess of the book value of shareholders' equity in 1976, but less than the book value of shareholders' equity in 1975 and 1974 (such book value taken from petitioner's federal corporation income tax returns, schedule L [balance sheets]), as shown below.

	<u>AVG. MARKET VALUE OF EQUITY</u>	<u>BOOK VALUE OF SHAREHOLDERS' EQUITY</u>	<u>EXCESS OF MARKET OVER BOOK VALUE</u>
1976	\$891,392,671	\$844,117,346	\$131,890,167
1975	541,595,699	674,887,662	(126,823,796)
1974	566,480,372	661,951,327	(88,315,621)

The examiner conducted a second comparison of market value to book value of equity, assuming a fifty-percent premium on the selling price of the stock. In acquisitions, it is not uncommon for the acquired corporation's stock to be purchased at a price in excess of the market price. In each year, an excess of market value over book value resulted; however, such excess did not approach the value of petitioner's property as reported on its New York franchise tax reports at Schedule G, Business Allocation (see Finding of Fact 3[a], [b] and [c]).

	<u>AVG. MARKET VALUE OF EQUITY, PLUS 50% PREMIUM</u>	<u>BOOK VALUE OF SHAREHOLDERS' EQUITY</u>	<u>EXCESS OF MARKET OVER BOOK VALUE</u>
1976	\$1,337,089,007	\$844,117,346	\$577,586,503
1975	812,393,549	674,887,662	143,974,054
1974	849,720,558	661,951,327	194,924,565

The examiner also referred to petitioner's Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, for 1976. Regarding the replacement cost of its timber holdings, petitioner reported, in pertinent part:

"It is important to note that the expenditures relating to the Replacement Cost of fee timber relate to expenditures incurred in the replacement process, not to the accounting treatment of such expenditures. Capitalization practices with respect to reforestation and timber management vary within the industry, and the Company cautions that no inference should be drawn that these expenditures, when made, would necessarily be capitalized, nor that the replacement cost amounts are a measure of net realizable value or economic value of the Company's fee timber.

* * *

In complying with the Replacement Cost requirements of the SEC, and assuming that the Company would replant its entire timberland acreage at 1976 site preparation and replanting cost levels, it is estimated that a total initial expenditure of \$225,152,000 would be required, which would be capitalized following the Company's accounting policy. However, site preparation and replanting costs represent only the initial or front-end costs of growing a tree... Assuming that the Company's timber-stand is one-half mature on the average, it is estimated that a total expenditure of \$229,147,000 for forestry management expenses, including property taxes, at 1976 cost levels would be required over the growth years to bring the timber stand to the assumed average state of current maturity."

6. The only other adjustment made by the corporation tax examiner which remains at issue revolves around petitioner's election to treat the cutting of timber as a sale or exchange under Internal Revenue Code section 631(a). For federal corporation income tax purposes, petitioner recognizes capital gain or loss in an amount equal to the difference between its adjusted basis for depletion of the timber cut during the taxable year and the fair market value of such timber on the first day of such taxable year. Because petitioner does not receive the benefit of this capital gain treatment for New York franchise tax purposes, it makes adjustments to inventory and entire net income on its franchise tax reports, as follows: (a) petitioner excludes from inventory timber cut (and therefore deemed exchanged under Code section 631[a]) but unsold during the taxable year; (b) petitioner increases inventory by timber deemed exchanged during a prior tax year but not sold until the tax year in question; (c) petitioner excludes from entire net income the capital gain recognized on trees cut but unsold during the tax year; (d) petitioner includes in entire net income the entire gain (selling price over adjusted basis for depletion) on the sale of timber in the tax year sold. These adjustments vary from year to year and may result in entire net income being greater or less than petitioner's federal taxable income for the same year. For the year 1976,

petitioner increased inventory and decreased entire net income for franchise tax purposes by the amount of \$7,687,755.

CONCLUSIONS OF LAW

A. That the corporation subject to Article 9-A taxation apportions its business income within and without New York (if so entitled) by application of the three-factor business allocation percentage.¹ Tax Law section 210.3(a).

The property factor is determined by:

"ascertaining the percentage which the average value of the taxpayer's real and tangible personal property within the state during the period covered by its report bears to the average value of all the taxpayer's real and tangible personal property wherever situated during such period...". Tax Law section 210.3(a)(1).

The pertinent regulations provide that the term "value" means "fair market value" and further that, "The same method of valuation must be used consistently with respect to property within and without the state". 20 NYCRR 4-3.1(a) and (b), effective for taxable years commencing on or after January 1, 1976; Ruling of State Tax Comm., March 14, 1962, section 4.13(a) and (b).

B. That the Audit Division properly required petitioner to include its timber holdings in the property factor of the business allocation formula at book value, consistent with petitioner's treatment of its other assets in such formula and with petitioner's treatment of its timber holdings for federal corporation income tax purposes. See Matter of Aerojet-General Corporation, State Tax Comm., July 7, 1980. Moreover, petitioner's claimed fair market value for its timber holdings appears somewhat excessive, in light of the average market value of its stock during the years at issue and the replacement cost of its timber as reported to the Securities and Exchange Commission.

¹ For taxable years beginning on or after January 1, 1976, the receipts factor, not at issue herein, is doubly counted.

C. That as above stated, petitioner elected to consider the cutting of its timber as a taxable event under the provisions of Internal Revenue Code section 631(a), which provides in pertinent part:

"If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 1 year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor."

Thus, in the year timber is cut, the excess of the fair market value, as of the first day of the taxable year in which the timber is cut, over the adjusted basis for depletion is recognized and taxed at capital gain rate. Treas. Reg. §1.631-1(d)(1). Upon the sale of the cut timber (whether during the same or a subsequent taxable year), the excess of the amount realized over such fair market value is considered and taxed as ordinary income. Treas. Reg. §1.631-1(e). Petitioner maintains that (1) absent its Code section 631(a) election, cutting would not constitute a realization event, and (2) because New York does not bestow capital gain treatment on the income which arises when timber is cut, gain is includible in entire net income only upon actual sale or exchange of the timber.

Entire net income is defined by section 208.9 as "total net income from all sources, which shall be presumably the same as the entire taxable income which the taxpayer is required to report to the United States treasury department..." (with certain modifications not relevant herein). The New York statutory scheme thus contemplates presumptive conformity to taxable income as

calculated by the taxpayer pursuant to the applicable provisions of the Internal Revenue Code.

Petitioner may not depart from the statutory definition of entire net income to exclude therefrom the gain attributable to the cutting of timber not sold in the same taxable year. Requiring petitioner's adherence to Tax Law section 208.9 does not invariably cause its entire net income to exceed its federal taxable income; for a particular taxable year, the opposite may be the case. Furthermore, for federal income tax purposes, petitioner's Code section 631(a) election is binding upon it for the taxable year for which such election was made and for all succeeding taxable years ("unless the Secretary on showing of undue hardship, permits the taxpayer to revoke his election...". Code section 631[a]). In determining whether to choose section 631(a) treatment, petitioner must have fully considered the ramifications of such an election, including the state tax consequences.


D. That the petition of Champion International Corporation is denied, and the notices of deficiency and the Statement of Tax Reduction or Overpayment issued on January 9, 1981 are sustained.

DATED: Albany, New York

STATE TAX COMMISSION

OCT 05 1984


PRESIDENT


COMMISSIONER


COMMISSIONER